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**COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT**

# Shadow Banking – Addressing New Sources of Risk in the Financial Sector

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## Introduction

Since the financial crisis began in 2007/2008, the European Commission has undertaken the biggest reform of financial services ever seen in Europe. The aim is to restore sustainable health and stability to this sector by addressing the shortcomings and weaknesses highlighted by the crisis.

The Commission's approach consists of tackling all financial risks, globally and comprehensively, and ensuring that the benefits achieved by strengthening certain actors and markets are not diminished by financial risks moving to less highly regulated sectors. Such regulatory arbitrage would greatly undermine the impact of the reforms. The Commission has therefore published a Green Paper on shadow banking in March 2012[1], with a view to gathering input on how best to tackle risks stemming from credit intermediation that involves **entities** and **activities** outside the regular banking system.

The shadow banking sector also features high on the international agenda. G20 Leaders have asked the Financial Stability Board (FSB)[2] to look into shadow banking in order to identify the main risks and make recommendations. The overarching aim, as reaffirmed on several occasions by the G20, is to eliminate all the dark corners in the financial sector and extend "regulation and oversight to all systemically important financial institutions, instruments and markets[3]".

The first FSB recommendations will be endorsed by G20 Leaders in St. Petersburg on 5-6 September 2013. The Commission has very actively contributed to the FSB work and the conclusions outlined in this communication are fully consistent with the FSB's orientations.

Following consultation on the Green Paper and at a time when financial regulation is set to be significantly reinforced and enhanced in Europe, the Commission wishes to set out its roadmap for the coming months which is aimed at limiting the emergence of risks in the unregulated system, in particular risks of a systemic nature[4]. These could arise especially through the shadow banking sector's interconnectedness with the regulated financial system.

While the notion of "shadow banking" has only recently been formally defined in the G20 discussions, the risks related to it are not new. The Commission together with the European co-legislators has already implemented or is in the process of implementing a number of measures to provide a better framework for these risks, such as the rules governing hedge fund activity[5] and reinforcing the relationship between banks and unregulated actors[6].

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[1] See http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf

[2] See G20 communiqué following the Cannes summit, November 2011.

[3] See G20 communiqué following the London summit, 2 April 2009.

[4] All of the actions proposed by the Commission in this document are consistent and compatible with the current multiannual financial framework (2007-2013) and the proposal for the upcoming period (2014-2020).

[5] Directive 2011/61/EU of the European Parliament and the Council on Alternative Investment Fund Managers (AIFMD) (OJ L 174 1.7.2011 p.1).

[6] For instance, the provisions related to securitisation exposures in the revised Capital Requirements as included in Regulation (EU) 575/2013 and Directive 2013/36/EU.

This Communication outlines a number of priorities where the Commission intends to take initiatives such as transparency of the shadow banking sector, establishment of a framework for money market funds, reform of rules for undertakings for collective investment in transferable securities (UCITS), securities law and the risks associated with securities financing transactions (principally securities lending and repurchase transactions) and establishment of a framework for interactions with banks. Furthermore, particular attention will be paid to supervisory arrangements in order to ensure that all major risks are adequately addressed. Moreover, certain areas require further analysis and will be clarified later this year, particularly on the basis of the Commission services' analysis and the work of the G20.

# 1. THE DEBATE ON SHADOW BANKING

## 1.1. Importance of shadow banking in the context of financial reform in the EU

- What is shadow banking?

Regulators define shadow banking as a system of credit intermediation that involves **entities** and **activities** outside the regular banking system[7].

It includes **entities** which:

– raise funding with deposit-like characteristics;

– perform maturity and/or liquidity transformation;

– allow credit risk transfer;

– use direct or indirect leverage[8].

Shadow banking **activities**, in particular securitisation, securities lending and repurchase transactions, constitute an important source of finance for financial entities.

- Why take a particular interest in this system?

In addition to risks associated with circumventing existing rules and the fact that these entities/activities can foster the surreptitious accumulation of high levels of debt in the financial sector, shadow banking needs to be monitored because of its size, its close links to the regulated financial sector and the systemic risk that it poses.

The first factor is size. Even if not entirely accurate, estimates of the size of the shadow banking system, both in absolute terms and as a share of the global financial sector, show that some of its components could be systemically significant. The latest studies by the FSB[9] indicate that the aggregate amount of shadow banking assets, proxied by the statistical category "other financial intermediaries", is about half the size of the regulated banking system. Despite the fact that shadow banking assets have decreased slightly since 2008, the total figure in 2011 was EUR 51 000 billion. In terms of geographical distribution, it is

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7 See FSB report 'Shadow Banking System, Scoping the Issues' of 12 April 2011. Five working groups were set up to work on i) the interactions between the shadow banking system and the banks, ii) the reduction of risks associated with money market funds, iii) the risks posed by "other" entities of the shadow banking system, iv) the incentive framework and transparency of securitisation transactions and v) the risks posed by securities financing transactions.

8 These may include ad hoc entities such as securitisation vehicles or conduits, money market funds, investment funds that provide credit or are leveraged, such as certain hedge funds or private equity funds and financial entities that provide credit or credit guarantees, which are not regulated like banks or certain insurance or reinsurance undertakings that issue or guarantee credit products.

9 See http://www.financialstabilityboard.org/publications/r_121128.pdf

concentrated in the United States (around EUR 17 500[10] billion) and in the EU[11] (Eurozone with EUR 16 800 billion and the United Kingdom with EUR 6 800 billion).

The second factor which increases risks is the high level of interconnectedness between the shadow banking system and the rest of the financial sector, particularly the regulated banking system. Any weakness that is mismanaged or the destabilisation of an important actor in the shadow banking system could trigger a wave of contagion that would affect sectors subject to the highest prudential standards.

Ultimately, the aim is to ensure that the potential systemic risks to the financial sector are properly covered and that opportunities of regulatory arbitrage are limited in order to strengthen market integrity and increase the confidence of savers and consumers.

### 1.2. Responses to the Commission's Green Paper

The numerous contributions received following the publication of the Green Paper[12] and the European Parliament's own-initiative report[13], which has added substantial value to the debate, highlight the importance of this issue to the financial system, the non-financial industry and public authorities.

A majority of respondents strongly supported initiatives aimed at laying down clearer rules for shadow banking. Many called on the Commission to adopt a proportionate approach that focuses, as a priority, on the activities or entities posing a high level of systemic risk to the economic and financial sector. This approach should, as far as possible, use the existing EU legal framework in order to ensure coherence and continuity.

The proposed definition of shadow banking set out in the Green Paper met with general approval by respondents. Some observers would have preferred a more specific definition but others stressed the importance of having a broad and flexible definition able to adapt to changes in the system. Many contributors were however unhappy with the term "shadow banking" which they felt has negative connotations. The Commission notes these concerns but itself uses the term neutrally and free of connotations. At this stage however it is very difficult to introduce alternative terminology, since this is by now a well-established term in the international debate.

There is a consensus on the need to reduce opportunities for regulatory arbitrage between the highly regulated sectors and other market segments where certain similar financial activities could be performed without being subject to the same level of regulation. The Commission's overarching aim is to implement a coherent approach that involves applying similar rules to activities that present similar risks.

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[10] The figures are shown in USD in the FSB study. This gives a total of USD 67 000 billion, USD 23 000 billion of which are in the United States, USD 22 000 billion in the eurozone and USD 9 000 billion in the United Kingdom.

[11] To allow international comparisons, FSB data is used. Studies have also been carried out by the Commission, the European Central Bank, ESMA, and the ESRB. These studies adopt different methodologies, definitions and data sources which may lead to substantial differences in the estimations.

[12] See http://ec.europa.eu/internal_market/consultations/docs/2012/shadow/replies-summary_en.pdf.

[13] See http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2012/2115(INI)

## 2. ARE THE REFORMS UNDERTAKEN AN ADEQUATE RESPONSE TO THE RISKS INHERENT IN SHADOW BANKING?

The Commission has set in motion an ambitious and unprecedented financial reform programme to which the European Parliament and the Council have given priority in terms of their role as co-legislators.

### 2.1. Measures aimed at financial entities

- Reinforcement of requirements imposed on banks in their dealings with the shadow banking system

Shadow banking entities can, to some extent, be monitored through their relationships with banks. Two sets of requirements are particularly important in this respect: requirements related to transactions concluded between banks and their financial counterparties and the accounting rules on consolidation.

First, measures have been taken to ensure that the interests of the persons initiating securitisation transactions are firmly aligned with those of the end investors. Since CRD II[14] entered into force at the end of 2010, credit institutions are obliged to check that the originator or sponsor institution of a transaction has an economic interest equivalent to at least 5% of the securitised assets. CRD III[15] then reinforced the capital requirements for the risks associated with securitisation transactions, particularly when these structures involve several levels of securitisation, and increased the prudential requirements for support given to securitisation vehicles[16].

Secondly, the accounting requirements regarding transparency also play an important role insofar as they allow investors to identify the risks borne by banks and their exposures to the shadow banking sector. The accounting standards on consolidation, in particular, determine whether or not an entity must be included on a bank's consolidated balance sheet. The amendments made by the IASB to the provisions of IFRS 10, 11 and 12, which will enter into force in Europe in 2014, will develop the accounting consolidation requirements and increase disclosure regarding unconsolidated structured entities. Furthermore, the Basel Committee has embarked on a review of prudential consolidation practices and will publish its conclusions by the end of 2014. The Commission is following these developments closely.

In 2010 the IASB strengthened disclosure requirements relating to off balance sheet exposures in the case of transfers of financial assets, which came into effect in Europe as from 1 July 2011 (IFRS 7). During the crisis, the lack of information on this type of commitment meant that investors and banking authorities were unable to correctly identify all the risks borne by banks.

- Reinforcement of requirements imposed on insurance companies in their dealings with the shadow banking system

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[14] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management (OJ L 302 17.11.2009 p.97)

[15] Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies (OJ L 302 14.12.2010 p.3)

[16] The Commission is also following the work carried out by the Basel Committee on this subject and its proposed amendments to the current arrangements.

The Solvency II Directive[17] also addresses a number of shadow banking issues through its risk-based approach, as well as by imposing strict risk management requirements, including a "prudent person" principle for investments. Like EU banking legislation, it provides for a total balance sheet approach where all entities and exposures are subject to group supervision.

Certain activities such as mortgage loan insurance[18], agreements on liquidity swaps with banks and direct granting of loans may raise specific concerns. The provisions relating to risk management and the capital requirements which will be specified in the technical measures implementing Solvency II. This will ensure that the risks inherent in these activities will be sufficiently covered and that opportunities for regulatory arbitrage will be limited. The Solvency II Directive establishes, in particular, that direct loans will be subject to capital requirements and that the creation of securitisation vehicles will need authorisation by supervisory authorities. The implementing rules of this Directive will include authorisation and on-going regulatory requirements relating to solvency, governance and reporting as far as insurance special purpose vehicles (SPVs) are concerned.

- A harmonised framework for alternative investment funds managers

Europe has already taken action with regard to financial actors who were previously not subject to regulation at EU level. The Alternative Investment Fund Managers Directive (AIFMD)[19] establishes harmonised requirements for entities responsible for managing and administering this kind of funds. Since 22 July 2013, these rules have to apply to all hedge funds, private equity and real-estate funds[20].

In order to receive approval, a manager must comply with requirements in terms of capital, risk and liquidity management, the appointment of a single depositary and rules on transparency to investors and supervisors. Leverage will be subject to special monitoring. If it proves to be excessive with regard to the risks to the stability of the financial system, the national authorities, on the recommendation of the European Securities and Markets Authority (ESMA), could impose limits on the use of leverage.

### 2.2. Measures undertaken to strengthen market integrity

- A framework for risk transfer instruments

Contagion between the regulated financial system and shadow banking can be serious and made worse by the lack of transparency, particularly in times of stress. The financial crisis has revealed the central role played by over-the-counter (OTC) derivatives, such as credit derivatives. The Regulation on OTC derivatives, central counterparties and trade repositories[21] (known as “EMIR” - European Market Infrastructure Regulation) requires the central clearing of all standardised derivative contracts, as well as margin calls for non-standardised contracts. This will make it possible to ensure that information relating to all European transactions on derivative products is stored in a trade repository accessible to all the supervisory authorities concerned. By ensuring that these transactions are transparent, it will be possible to clearly define the role of entities in the shadow banking system.

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[17] See http://ec.europa.eu/internal_market/insurance/solvency/

[18] The Commission services will take into account in particular the principles of the Joint Forum which will be finalised by the end of 2013. http://www.bis.org/press/p130211.htm.

[19] Directive 2011/61/EU of the European Parliament and the Council on Alternative Investment Fund Managers (AIFMD) (OJ L 174 1.7.2011 p.1).

[20] By the end of the third quarter of 2012 the total assets under management by these alternative funds amounted to around EUR 2 500 billion (source: EFAMA).

[21] Regulation (EU) No 648/2012 of the European Parliament and of the Council of 4 July 2012 on OTC derivatives, central counterparties and trade repositories (OJ L 201 27.7.2012 p. 1)

Within the framework of the implementation and future reviews of the Regulation, the Commission will assess the coverage of the entities belonging to the shadow banking system and determine whether supplementary initiatives are necessary to ensure that these entities are not exempt from the obligations regarding compensation and transparency imposed through the central repositories.

In addition, the short selling regulation[22] addressed some of these concerns by increasing transparency for credit default swap positions and banning uncovered sovereign credit default swaps.

- Strengthened securitisation arrangements

Securitisation is a financing method that is important for the effective financing of the economy. However, it has also been used for significant transfers of credit risk from the traditional banking system without sufficient safeguards.

Requirements similar to those set out in CRD II are laid down for insurance companies (Solvency II), alternative investment fund managers (AIFMD) and undertakings for collective investment in transferable securities (UCITS).

The European regulatory framework is in line with the recommendations issued on 16 November 2012 by the International Organization of Securities Commissions (IOSCO)[23]. The Commission will continue to pay close attention to these principles in order to guarantee equal treatment and a good understanding of the risks at international level. Strengthening the securitisation framework also involves taking robust measures in terms of transparency. The Commission welcomes any initiatives aimed at increasing transparency and reinforcing the standardisation of disclosure. Initiatives led by central banks on collateral[24] and by industry, such as the implementation of labelling[25] will allow supervisors to better monitor risks and make it possible for investors to analyse the risks in greater depth. This should contribute to create more beneficial conditions for the revival of this market.

- An enhanced framework for rating agencies

Credit rating agencies play an important role in the shadow banking chain. Rating actions have a direct impact on the actions of investors, borrowers, issuers and governments. The financial crisis has highlighted the importance of the assessments made by rating agencies especially in the decision-making process of investors and how these facilitated the over-extension of credit and pro-cyclical reactions in many cases also in the shadow banking sector by facilitating creation of excessive leverage. The EU has adopted three regulations[26] with a view to providing a clearer framework for these agencies. This new framework will reduce overreliance on external ratings, improve the quality of ratings and increase accountability of

[22] Regulation (EU) No 236/2012 of the European Parliament and of the Council of 14 March 2012 on short selling and certain aspects of credit default swaps (OJ L 86 24.3.2012 p. 1)

[23] See http://www.iosco.org/library/pubdocs/pdf/IOSCOPD394.pdf.

[24] See, for example, the initiatives taken by the Eurosystem and by the Bank of England.

[25] The two examples are the PCS (Prime Collateralised Securities) Label for the asset-backed securities market and the European Covered Bond Council (ECBC) Label for the covered bond market.

[26] See http://ec.europa.eu/internal_market/rating-agencies/index_en.htm referring to the most recent Regulation (EU) No 462/2013 of the European Parliament and of the Council of 21 May 2013 amending Regulation (EC) No 1060/2009 on credit rating agencies Text with EEA relevance (OJ L 146, 31.5.2013, p. 1–33) and Directive 2013/14/EC of the European Parliament and of the Council of 21 May 2013 amending Directive 2003/41/EC on the activities and supervision of institutions for occupational retirement provision, Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS) and Directive 2011/61/EU on Alternative Investment Funds Managers in respect of over-reliance on credit ratings (OJ L 145, 31.5.2013, p. 1–3)

credit rating agencies. The third Regulation (CRA3) which entered into force on 20 June 2013 will help to limit conflicts of interest by making the agencies accountable and will also reduce excessive and automatic dependence on these ratings. Those measures in conjunction will help making the shadow banking system healthier and more resilient.

## 3. ADDITIONAL MEASURES PROVIDING A FRAMEWORK FOR THE RISKS ASSOCIATED WITH SHADOW BANKING

Five priority areas can be identified: increasing transparency in shadow banking, providing an enhanced framework for funds, particularly money market funds, developing securities law to limit the risks associated with securities financing transactions, strengthening prudential arrangements in the banking sector and improving the way in which supervision of shadow banking is organised.

### 3.1. Increased transparency

In order to be able to monitor risks in an effective manner and intervene when necessary, it is essential to collect detailed, reliable and comprehensive data. Authorities must continue in their efforts to supplement and enhance their statistical tools, such as the granularity of their flow of funds data. At this stage there are four projects that merit priority treatment.

- Supplementing initiatives regarding the collection and exchange of data

There is a need for developing a monitoring framework for shadow banking risks in the EU. A periodical quantitative assessment should take place at least annually and should notably identify the way of bridging information gaps that prevent an adequate and comprehensive assessment. In this context, the Commission is looking forward to the contributions of the new ESRB working group and its concrete proposals including specific risks indicators. At international level, the FSB annual monitoring exercise offers a good overview of these developments and should be further completed. In addition the joint FSB - International Monetary Fund (IMF) work on a framework for the collection and sharing of data on large banks of systemic international importance (the Data Gaps Initiative) could be usefully enhanced by collecting data on sectoral interconnectedness which would be useful for monitoring the risks associated with shadow banking.

- Developing central repositories for derivatives within the framework of EMIR and the revision of MiFID

EMIR requires registration of all derivative transactions in central repositories (trade repositories). These reporting requirements will be phased in as of beginning 2014. In terms of monitoring shadow banking, the collection of this data by trade repositories is a major step forward insofar as it helps to better identify transfers of risks. These repositories provide immediate access to detailed information on the interconnectedness of the different actors. For example, they make it possible for supervisors to monitor who is buying or selling protection on certain markets (credit derivatives, rate and equity derivatives). If entities belonging to shadow banking, like hedge funds, are dominant or bear significant risks, they could be identified by supervisors.

The revision of the Markets in Financial Instruments Directive (MiFID)[27] will also make it possible to increase the transparency of bonds, structured products, derivative instruments and emission allowances. This proposal also extends the scope of the directive to include activities such as high-frequency trading. By making these activities conditional upon approval being granted, the proposal will allow the authorities to identify and monitor the risks posed by

[27] See http://ec.europa.eu/internal_market/securities/isd/mifid_en.htm

high-frequency traders to the markets more easily, even if these traders belong to the shadow banking system.

- Implementing the Legal Entity Identifier (LEI)

At the request of the G20, the FSB has established a global governance body - the LEI Regulatory Oversight Committee – in order to develop and manage a new standard ensuring a unique identifier for each legal entity that is party to a financial transaction. The LEI will help supervisory authorities to monitor all financial actors, irrespective of whether they are regulated, and their financial transactions, on a cross-border basis. In particular, it will make it possible to identify risk concentration in the financial system, simplify reporting systems and improve the quality of data and risk management by financial operators. The LEI will have an impact on shadow banking because it will make it possible to collect much more information on the entities that carry out financial transactions.

The LEI Regulatory Oversight Committee held its first two plenary meetings in 2013. With the backing of the FSB, it will gradually establish the structure responsible for managing the standard, which will be based on a central unit and on a network of local operators around the world. The LEI will initially be used for the reporting of derivative products in Europe and the United States. Its use will then gradually extend into other areas, such as the implementation of regulation related to banks, hedge funds, credit rating agencies and financial markets more widely.

Three issues should be highlighted in this regard. First, the Commission encourages the establishment in Europe of local operating units to assign identifiers to European companies. Secondly, it will pay particular attention to the transitional stage preceding the implementation of the definitive identifier, in order, to ensure that transitional identifiers are globally coherent and recognised as such by the LEI Committee. In this respect reporting on derivatives should, in each jurisdiction, draw on all of the identifiers recognised by the Committee. Finally, the Commission will ensure an appropriate balance between public and private actors in the project, especially in the context of the creation of the central operating unit that will serve as the pivot for the system.

The Commission will consider the possibility of preparing a legislative proposal, which would make it possible to transpose the obligation to use the LEI into the European legal framework.

- The need to increase transparency of securities financing transactions

The European Systemic Risk Board (ESRB) and the FSB analysis have shed light on the lack of reliable and in-depth data on repurchase agreements and securities lending transactions. This data is essential to observe the risks associated with interconnectedness, excessive leverage and pro-cyclical behaviours. It will permit the identification of risk factors such as excessive recourse to short-term funding to finance long-term assets, high dependence on certain types of collateral and shortcomings in assessing them. These gaps are a concern, particularly in view of the opacity of collateral chains which increases the risk of contagion.

While actively contributing to international discussions on this issue, the Commission is closely following the current ECB initiative to establish a central repository to collect detailed data on repurchase transactions in the EU in real time. This work will (i) identify the data necessary for monitoring these transactions and (ii) analyse the data already available, particularly in infrastructure. The ECB recently reiterated the need for a reporting framework at EU level[28], while the ESRB has concluded that setting up a central repository at European

[28] See http://www.ecb.europa.eu/pub/pdf/mobu/mb201302en.pdf#page=90

level would be the best way to collect data on securities financing transactions[29]. The Commission will pay specific attention to this work within the framework of the FSB recommendations. In the light of these developments, it will assess whether transparency at EU level has improved, while reserving the right to propose any appropriate measures to remedy the situation.

### 3.2. An enhanced framework for certain investment funds

- Specific legislative measures to provide a better framework for money market funds

The financial crisis has shown that money market funds, which were seen as relatively stable investment vehicles, could pose a systemic risk. These funds are a useful tool for investors because they offer characteristics similar to those of bank deposits: instant access to liquidity and stability of value. However, money market funds are nonetheless investment funds, subject to market risk. During periods of high market turbulence, it is difficult for these funds to maintain liquidity and stability, particularly in the face of investor runs. Consequently they could pose a serious risk of contagion.

Following the consultation organised in 2012 on remodelling the asset management sector[30] and with a view to responding to the European Parliament resolution[31], the Commission published together with the present Communication a proposal for a Regulation that will apply to all European money market funds without exception <**http://ec.europa.eu/internal_market/investment/money-market-funds/index_en.htm**>. These proposals take into account the work carried out at both international IOSCO and FSB) and at European level (ESRB recommendations[32] and ESMA guidelines. They will strengthen, in particular, the quality and liquidity of the asset portfolios held by these funds and will establish, for some of these funds, capital buffers in order to cover the gaps in valuation associated with fluctuations in their asset value.

- Strengthening the UCITS framework

In the context of the general review of the UCITS Directive (a public consultation was carried out in 2012), the Commission will tackle other problems associated with asset management. A global assessment of the framework in which certain funds[33] can operate will be carried out, including the way in which certain investment techniques and strategies are used.

As a key feature, the review will examine how investment funds use securities financing transactions. Funds will have to ensure that the use of this type of transaction does not impair their liquidity. These transactions generally go hand in hand with collateral exchange covering the funds against counterparty risk. The eligibility criteria and diversification of assets posted as collateral will be reviewed in order to ensure that potential losses are covered effectively and immediately in the event of default of a counterparty. Particular attention will be given to funds connected by this type of transaction to the banking system.

### 3.3. Reducing the risks associated with securities financing transactions

Beyond the fund management industry, securities financing transactions – mainly repurchase agreements or securities lending transactions – played a central role in the excessive level of indebtedness in the financial sector. In addition since the financial crisis first began, financial

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[29] http://www.esrb.europa.eu/pub/pdf/occasional/20130318_occasional_paper.pdf?e85401cf104ef718cfe83797b55c87f6

[30] http://ec.europa.eu/internal_market/consultations/2012/ucits_en.htm.

[31] See http://www.europarl.europa.eu/oeil/popups/ficheprocedure.do?lang=en&reference=2012/2115(INI)

[32] http://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2011_1.en.pdf?5c66771e20fc39810648296a2c6102d9

[33] The approach will be wider than the exchange traded funds (ETF) category,

intermediaries have frequently been forced to use security (collateral) to obtain financing in the markets. This collateral covers lenders against counterparty risk but can also be re-used by lenders

In the EU, this collateral usually takes the form of securities, which can be re-lent to other financial intermediaries in order to guarantee or secure new credit transactions. If this collateral is lodged in cash, it can be re-invested. The reuse or rehypothecation of securities generates dynamic collateral chains in which the same security is lent several times, often involving actors from the shadow banking system. This mechanism can contribute to an increase in leverage and strengthen the pro-cyclical nature of the financial system, which then becomes vulnerable to bank runs and sudden deleveraging. Furthermore, the lack of transparency of these markets makes it difficult to identify property rights (who owns what?) and to monitor risk concentration as well as identify counterparties (who is exposed to who?). The recent cases in which major financial intermediaries have filed for bankruptcy (e.g. Lehman Brothers) are a testament to these problems. They are sometimes accentuated by the interconnectedness of financial institutions and the collateral transformation strategies implemented by certain financial actors. Therefore the default of a large financial institution could also destabilise the securities markets.

In-depth work has been carried out to better understand and learn from these events. In order to resolve these problems, the Commission is considering a legislative proposal regarding securities law.

### 3.4. Strengthening the prudential banking framework in order to limit contagion and arbitrage risks

The risks posed by shadow banking to regulated banks could be addressed in two main ways:

- Tightening the prudential rules applied to banks in their operations with unregulated financial entities in order to reduce contagion risks

The Capital Requirements Regulation (CRR)[34] and Directive (CRD IV)[35], which will apply from 1 January 2014, will tighten the solvency rules applied to banks, in particular regarding capital requirements for holdings in financial entities, including unregulated entities.

Furthermore, this prudential reform will make it obligatory for banks to cover with additional own funds the counterparty risk generated by certain OTC derivative transactions with shadow banking counterparties. This reform provides for the imposition of an additional capital requirement to cover potential losses resulting from changes in the market value of these derivatives where the solvency of the counterparty to these derivatives deteriorates if and only if the counterparty is not exempted from this rule (credit value adjustments or CVA). A number of shadow banking entities are important counterparties in these derivative transactions. Banking institutions should therefore be encouraged to conclude fewer transactions with unregulated entities.

Furthermore, this legislation provides for new liquidity rules[36] which should result in an increase in the maturity of banks' financial liabilities and should reduce recourse to short-term financing, often granted by entities such as money market funds.

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[34] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L 176 27.6.2013 p.1)

[35] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176 27.6.2013 p.338)

However, as these measures will affect all financial counterparties of banks equally, whether or not these counterparties are regulated, two new specific measures have been introduced to reduce the risks that shadow banking poses to banks:

– Starting from 2014 banks will be required to report to their supervisors their main exposures to unregulated entities as well as exposures arising from repurchase agreements and securities lending transactions;

– By the end of 2014 the European Banking Authority (EBA) is requested to prepare guidelines to limit banks' exposure to unregulated financial counterparties, while the European Commission is required to determine, by the end of 2015, whether it is appropriate to establish such limits in the EU legislation after considering the work carried out at both European and international levels.

- Thinking about a possible extension of the scope of application of prudential rules in order to reduce arbitrage risks

By extending the scope, it would be possible to respond to the concerns notably expressed in the Parliament's initiative report which suggests the application of prudential rules to entities performing activities similar to those of banks without a banking licence.

It is not possible to discuss shadow banking without considering the scope of application of the EU banking prudential rules. According to EU legislation,[37] any "undertaking whose business is to receive deposits or other repayable funds from the public **and** to grant credit for its own account" is required to meet banking prudential requirements. However, the concept of "repayable funds from the public", and even the concepts of credit and deposits can be interpreted in different ways, meaning that financial entities performing similar activities may be qualified as credit institutions in some Member States but not in others. As a result these entities may not be subject to the same rules within the European Union.

A precise assessment of the way in which the definition of credit institutions is applied and the way in which credit institutions are identified in the 28 Member States is therefore necessary. If the results of this assessment show specific problems, the Commission could clarify, by means of a delegated act, the definition of a credit institution for the purposes of prudential banking regulation on the basis of Article 456 of the CRR.

The entry into force of the CRR – which is a regulation as opposed to the previous situation where the definition of credit institutions was contained in a Directive - means that only financial entities fulfilling both deposits-taking and credit activities will be qualified as "credit institutions" starting from 2014. Until now Member States have been allowed to define a credit institution more broadly when transposing the Directive 2006/48/EC. For instance, in some Member States, non-deposit taking credit providers, such as finance companies, may be qualified as credit institutions and hence be required to fulfill EU banking prudential rules. Some Member States might take the decision to continue to apply the banking prudential requirements or adjusted prudential requirements to these credit providers. Others might decide not to apply specific rules. This may result in different prudential treatments across Member State as regards entities which do not fulfil the requirements of the definition of a

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36 These new rules will be finalised once the impact studies will have been completed.

37 Article 4(1) of Directive 2006/48/EC of the European Parliament and the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast) (OJ L 177 30.6.2006 p.1) and point (1) of Article 4(1) of Regulation (EU) No 575/2013 of the European Parliament and the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) 648/2012 (OJ L 176 27.6.2013 p.1).

credit institution in CRR. Including in this assessment all financial entities performing activities similar to those performed by banks without being classified as credit institutions will help to assess the differences in national prudential treatments[38].

EBA will be requested to assess the size of those financial entities falling outside the scope of European banking prudential regulation. As this task will require a horizontal assessment of the financial sector, EBA will also be able to draw on the work carried out by other European supervisory authorities.

Such an initiative would also make it possible to strengthen the European macro-prudential supervision framework that makes it obligatory for banks to maintain a countercyclical capital buffer at the request of supervisory authorities when they deem the volume of lending to be excessive. An instrument of this nature can be fully effective only if it takes into account all financial entities that grant credits and not just credit institutions.

The Commission will also consider forthcoming FSB recommendations on the other entities from the shadow banking system which are not currently subject to a suitable supervision framework and will propose, if necessary, legislative measures to remedy this.

### 3.5. Greater supervision of the shadow banking sector

Shadow banking is by its very nature multifaceted and dynamic. It adapts to changes in both markets and regulations. The Commission therefore requests national and European authorities to maintain constant vigilance and be equipped with the supervision tools available for this system.

The diffuse nature of shadow banking makes performing such supervision all the more complex. With regard to the competencies currently attributed to the supervisory authorities, responsibility for supervision has yet to be clearly defined or lacks depth. In the light of this, it is essential that both national and European authorities take measures to ensure the establishment of a suitable and comprehensive monitoring system.

At **national level**, each Member State must ensure that the risks inherent in shadow banking are identified and monitored. This task is often performed by the bodies in charge of the macro-prudential supervision of the financial sector, if such bodies exist, in collaboration with central banks and sectoral supervisory authorities. The Commission will pay close attention to the quality of this monitoring and to whether there is close cooperation between the national authorities. As the shadow banking system is global, it must be possible to perform risk analysis on a cross-border basis.

At **European level**, work is under way regarding the assessment, identification and monitoring of entities and risks posed by shadow banking. Preliminary work has been carried out within the ESRB and the European supervisory authorities (EBA, EIOPA, ESMA). All of this work must be stepped up and coordinated, making sure that no source of systemic risk goes unnoticed by supervisors. It must reduce arbitrage opportunities among financial sectors and cross-border possibilities of circumventing prudential rules.

This aspect, as well as the possible need to clarify the institutional role of each authority, will be notably tackled within the framework of the review of the European System of Financial Supervisors (ESFS), to be performed by the Commission in 2013. This assessment will take into account, in particular, the existence of effective procedures to collect and exchange information on shadow banking. The discussion will also take account of the developments associated with the implementation of the single supervisory mechanism.

[38] For example, this is the case for consumer credit, factoring and even leasing activities which are performed without a banking licence in certain Member States.

### 3.6. Conclusion

The shadow banking sector should not be seen solely in terms of the risks that it poses; it is also essential to acknowledge the important role that it plays within the financial sector. It constitutes an alternative financing channel that is essential to the real economy, particularly at a time when traditional actors in the banking system are reducing financial support.

The actions described in this Communication are not exhaustive and the Commission will continue to assess whether supplementary measures are necessary to ensure that a suitable framework is established for shadow banking. This dynamic and forward-looking approach is necessary in order to respond to the changes in this system, which is constantly adapting to the regulatory context.

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## Main measures in the field of shadow banking[1]

| | 2009-2012 | 2013 | | 2014 and beyond |
|---|---|---|---|---|
| **Indirect approach through Banking regulation** | • CRD 2 implemented in 2010<br>• CRD 3 implemented in 2011<br>• Amendment to IFRS 7 in 2011 (incl. certain securitisation risks) | • EU consultation on banking structural reform (Liikanen report follow-up) | • COM proposal on structural reform | • CRD 4 implementation as of 01/01/2014<br>• Implementation of amendments to IFRS 10, 11, 12 (consolidation requirements /disclosure) |
| **Specific initiatives in the banking sector / Shadow Banking** | | | • EBA assessment on the scope of banking prudential regulation to start (final report in 2014) | • EBA report on limits to unregulated counterparties exposures |
| **Indirect approach/ Insurance sector** | | • EIOPA Reports for Omnibus II trilogue | • Omnibus II trilogues to be concluded | • Delegated Acts for Solvency II (including capital requirements and risk management requirements) |
| **Asset management sector** | • IOSCO/FSB/ESRB work on policy recommendations for Money Market Funds | • AIFMD implementation (transposition deadline 22/07) | • Money Market Funds regulation proposal (04/09) | • UCITS review including investment techniques and strategies of the funds |
| **Risk transfers framework** | • EMIR into force since 2012 | • Technical standards adopted (March); | | • Technical standards on contracts subject to mandatory clearing obligation to be adopted (Q2) and to enter into force (Q3) |
| **Reducing risks associated with securities financing transactions** | | • FSB work on policy recommendations related to repo and securities lending transactions | | • Securities Law proposal including elements on property rights and transparency. |
| **Enhancing Transparency of Shadow Banking** | | • Establishment of the LEI Regulatory Oversight Committee<br>• Shortselling regulation implementation (increased transparency for CDS and banning uncovered sovereign CDS)<br>• MIFID revision / increase the scope of transparency | | • Entry into force of the reporting requirements for derivatives transactions to trade repo (EMIR) (Q1)<br>• Monitoring framework to be develop by authorities (eg. ESRB working group),<br>• Securities law proposals /Specific actions for securities financing transactions (eg. ECB initiative on a trade repo)<br>• Legal identifier (LEI) implementation phase |
| **EU Supervisory framework** | | • EFSF review by the Commission | | • See if further actions are needed to enhanced shadow banking oversight in the EU |
| **Rating agencies** | • CRA 1 into force in 2009<br>• CRA 2 into force in 2011 | • CRA 3 into force since 20 June 2013 (addressing notably conflict of interests, excessive reliance on ratings) | | |
| **Resolution tools for non-banks** | • COM public Consultation on non-bank resolution | • Internal assessment / works at international level (FSB on resolution and CPSS-IOSCO on recovery of FMIs) | | • COM initiative (legislative proposal on recovery and resolution of CCPs and Communication on the policy orientation in relation to other non-financial institutions) |

[1] All dates are indicative.